



## New Study Finds Target Date Industry Has Serious Shortcomings

By Robert Huebscher

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Target Date Analytics (TDA), a new company with a mission to measure the effectiveness of target date funds, has released its first study of the industry. TDA looked at 38 fund companies with target date offerings, and measured the performance, risk, and fees of each fund.

The results are not encouraging. As a whole, target date funds fail to shift assets into safer (fixed income) securities as the target date approaches, fail to adequately diversify portfolios, and – which will be no surprise to many – those that are actively managed fail to outperform passive benchmarks.

We have written [previously](#) about TDA and their methodology. TDA was kind enough to allow us to preview their initial study of the industry.

Target Date Analytics has a complete study of all 38 fund companies offering target date funds as of 12/31/07. This comprehensive 150+ page report provides 4 pages of important insight on each fund company. Popping the Hood III is available at [www.TDBench.com](http://www.TDBench.com).

We also spoke with Ron Surz, Craig Israelsen, and Joe Nagengast, Principals with the firm, about the study's findings. Nagengast's firm, Turnstone Advisory Group, published two prior versions of the study, and the research is now consolidated through TDA.

Surz believes the TDA report is the only comprehensive analysis of the target date industry directed to plan sponsors. New regulations allow target date funds to be a default option for 401(k) plans. But, as Surz notes, "this does not let plan sponsors off the hook when it comes to selecting the best available funds and fund companies." As a practical matter, most plans choose only one or two fund companies to provide target date funds for 401(k) participants. Since sponsors make this selection at the fund company level, it makes sense to grade the industry by fund company, rather than by fund.

### The Target Date Industry is too Aggressive

On the whole, target date fund companies leave too much of their assets in equities on the target date, exposing retirees to unnecessary risk. TDA believes that, on the target date, 100% of assets should be in "safe" securities, either cash or fixed income. Surz says "on the target date, advisors should be restructuring



for the distribution phase, into annuities or other vehicles.” He added, “the lessons of the last eight months are that advisors can pay a high price if retirement portfolios are not properly allocated as the target approaches.”

In fact, of the 38 mutual fund companies studied, none had an equity allocation of zero on the target date. Allocations ranged from 20% to 80% of funds in equities, with a mean of approximately 40%.

As an explanation for this phenomenon, Surz believes fund companies may be hoping retirees will keep their assets with the equity funds offered by the fund company once the target date is reached. Alternatively, fund companies may be simply seeking to maximize revenue from equity funds and their higher management fees.

TDA measures Aggressiveness by comparing the asset allocation of each fund to a target asset allocation based on index funds. It measures whether the fund outperformed the index allocation. Of the 38 mutual fund companies covered in the study, only 14 have funds with three years of history, which is the minimum data requirement for TDA to calculate performance. For these 14 fund companies, their Aggressiveness scores were uniformly high and positive for the last three years, resulting from the strong performance in the US equity markets and from the funds’ over-allocation to equities.

Advisors should not be reassured by the high and positive Aggressiveness scores. They indicate an excessive level of risk in asset allocation, which is an industry-wide phenomenon.

Surz also notes that the 24 newer entrants into the target date industry are charging fees above the industry average. He would have expected them to be more competitive with their fees in order to attract market share, and now worries that some fund companies see target date funds as an opportunity to cash in on high fees.

### **Funds Lack Diversification**

TDA finds that the target date industry utilizes asset allocations which place too much emphasis on US equities, and fail to diversify adequately into non-US markets, as well as into alternative asset classes, like real estate and commodities. To measure this, TDA calculates a Concentration measure, by comparing each fund’s asset allocation against a broadly diversified allocation.

Surz believes that funds have been sacrificing about 50 basis points in annual return due to this lack of diversification. To explain this, he notes that the starting point for most fund companies was an allocation based on the S&P 500 and the



Lehman Aggregate fixed income index, and the industry has evolved slowly from this point. He says, “as the target date industry matures, portfolios will get more diversified.”

None of the 38 fund companies exhibited truly diversified portfolios.

### **Active Management Subtracts Value**

Passive management advocates will be happy to hear that the target date industry has failed to do a good job with its actively managed funds. To measure this, TDA defines a Selection measure. It is very simple, and measures the actual return on a fund against the return with the same asset allocation using index funds. The difference is the Selection effect. Surz says “active management is a persistent and consistent detractor of performance.”

The cost of active management is generally between 60 and 70 basis points per year, although it is as high as 150 basis points for longer-dated funds (which maintain higher allocations to equities).

Three firms (Vanguard, Nationwide, and Seligman) utilize exclusively index funds in their target date offerings. We noted that Vanguard had a negative Selection effect, but this is an artifact of their particular choice of passive indices. NestEgg, TDAX, and Wells Fargo buy individual securities in an attempt to replicate passive indices.

Interestingly, Russell scores the best among active managers, but their Selection effect is still negative.

### **The Best Ballerina in Waco**

Israelsen says winning the competition among target date fund companies is like becoming the “best ballerina in Waco.” We’ve never attended a ballet in Waco, but we suspect that good ballerinas are scarcer there than good high school football players. There is clearly room for improvement among the target date providers. Surz is careful to point out that he and his firm do not want to be hypercritical of the industry. Surz believes that TDA has taken an important step with their offering of industry standard benchmarks for target date funds, and remains very optimistic about the role of these funds in retirement portfolios.

Nagengast stresses that target date funds are delivering results that are “much, much better than leaving individuals on their own and are moving the nation’s individual accounts to more prudently allocated positions, but they still have a way to go.”



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